Martin Mayer
The Brookings Institution
1775 Massachusetts Avenue NW
Washington, DC 20036

Testimony May 14th, 1997 to the Subcommittee on Finance and Hazardous Materials (!) of the House Commerce Committee

My identikit tells you that I am a guest scholar at The Brookings Institution, but of course I speak only for myself.

Virtually everyone will say today that technology has changed all aspects of the relationship between traditional commercial banking (defined as the continuing interposition of the bank's credit between the borrower and the depositor who provides the funds) and investment banking (in which the intermediary introduces borrower and lender, and then disappears). Banks no longer fund their loans primarily from insured deposits--only 15% of the liabilities of the American banking system are in the form of insured checking accounts. Debt instruments trade pretty much the same at banks and in investment houses whether the source of the instrument is a bank loan that has been participated out to a number of banks and insurance companies and pension funds and mutual funds or a junk bond underwritten by an investment house and purchased by the same banks and insurance companies and pension funds and mutual funds. All the customers are supposedly sophisticated institutions, and they are--at least theoretically--well-informed about the paper they buy.

But there remains a difference, which is crucial to your deliberations. The bonds are priced in the market, and those prices are reported to the public through various means, most effectively, recently, by the Bloomberg service. Participated loans are traded in a market that does not report to the public. In the modern world, many of these instruments carry or can be converted to implicit options that affect the markets for many other instruments, some of them less than entirely cognate with the tradable paper. Thus the fact that pricing is more public and more accurate for bonds than for participated loans can create misperceptions in other markets, too, and significant informational advantages for the dealers as against even their most sophisticated customers.

One notes in passing that all financial instruments held by investment banks must be valued every day at their market price that day, according to Generally Accepted Accounting Principles, while banking regulators permit banks to carry both loans and bonds at their face value so long as the bank has an intention to hold the paper to maturity. In times of rising interest rates, when compelling banks to recognize the reduced value of loans and bonds could impair their reported profitability and even their solvency, bank examiners are instructed to be very kind in deciding which instruments are part of a trading inventory that must be marked and which are

part of an investment portfolio that can be carried at higher values.

The larger issue is the clash of cultures between banking and the securities markets. Banks are run to a large extent in secret--indeed, Congress has passed secrecy laws to protect the confidentiality of bank investment portfolios. Nor is this demand for secrecy without justification. Borrowers have reason not to wish the fact or terms of their borrowings to be known (especially as these terms may and do change from time to time, and knowledge of the changes could give both competitors and business partners information the business has valid reasons to consider privileged). And given the danger of contagious runs that could damage the economy, banking regulators fear that information reducing confidence in any one well-known bank could harm the banking system and the economy as a whole. Both these arguments, incidentally, are of diminishing validity. As the banks' portfolios become increasingly securitized, there will be less reason to keep their contents secret, and as payments move toward real time gross settlement the danger of contagious runs will diminish.

Without buying completely into the public choice theories of my friend Ed Kane and his followers, Congress should keep it in mind that the most significant source of regulato-

ry authority over banks today is the power of the examiner and his superiors to value the assets. Valuation of the assets, among other things, determines whether the bank is in compliance with capital standards. Most economists, I think, would wish to see the banking industry like other industries subjected to market discipline rather than regulatory fiat. But markets cannot properly value banks because the value of the portfolio hides behind regulatory accounting rules and the decisions of the bank examiner.

Congress in FDICIA mandated prompt closure for troubled banks by the regulators themselves, but it is no secret that the regulators do not intend to be bound by that law. Internal memos resisting the law leaked from the Fed soon after its passage, and this year we have the spectacle of some monoline banks being kept afloat by kind hands in Washington despite the violence of their losses from default by consumers who weren't creditworthy from the start and were thus willing to borrow on usurious terms. In any event, support or closure of troubled institutions by regulatory decision is the antithesis of market discipline.

Markets by contrast are public information systems, and over the years both participants and all but a handful of economists have learned that the exploitation of information advantages will reduce their breadth, depth and resilience.

Our securities acts breathe a spirit of disclosure and transparency, and for all its faults the Securities and Exchange Commission normally understands that its first function is to police the creation and transmission of information. To the extent that we believe in markets, we must seek to strengthen the role of the SEC and diminish the rule of the banking regulators, whose fundamental trope is toward secrecy. Markets need regulation--somebody has to certify that the scales give honest weight because the shoppers can't do that for themselves--and they do not need supervision. Someone, moreover, must watch the watchmen, making sure that the scales authority does not extort from merchants or help them cheat the public, and the banking regulators often deny public access to the reasons for their decisions.

McGeorge Bundy once observed that the fundamental role of law "is to prevent the natural unfairness of human society from becoming intolerable." The fundamental role of government in markets is to remedy the natural information disadvantages of public participants. This work has been assigned to the SEC, not the banking regulators. Until the day comes when the banking regulators are prepared to publish the examiners' findings of the condition of banks--which Bill Isaac recommended in his parting statement as chairman of the FDIC a dozen years ago and the Shadow Regulatory Committee

has often advocated--it would be intolerable to permit the regulation of banks' activities in the securities markets by the Comptrollor or the Federal Reserve. Banking regulators will impede the distribution of the information markets require.

Comptroller Ludwig's insistence that banks can perform investment banking and brokerage activities through subsidiaries is a truly lousy idea. No firewalls could protect the parent bank from a firestorm in its securities subsidiary. What is needed is an impenetrable corporate veil, permitting the securities end of the holding company to go bust without destroying the solvency of the bank. Thus the Federal Reserve model of a holding company with a separately incorporated subsidiary is the correct procedure. But then "entity" or "umbrella" regulation by the banking supervisor, as Chairman Greenspan recommends, destroys the virtue of the distinct subsidiary. In fact, all the larger banks that have created Section 20 subs in response to the Fed's loosening of Glass-Steagall restriction have voluntarily opted for SEC regulation. Absent SEC regulation, bank subsidiaries in the securities market would be regarded with suspicion in the markets.

Reading Chairman Greenspan's recent speech to the Chicago Bank Structure Conference should convince any observer

that the Fed is interested only in the profitability and stability of the bank. It is the need of the regulator to see all the aspects of the holding company, not the need for the public to receive and evaluate information on the operation of the company, that drives the Chairman's analysis. "Regulation," he argues, "must fit the architecture of what is being regulated." The suggestion that banks will police each other is theoretically sound but historically wrong, and especially dangerous now, when the Fed is encouraging bilateral netting, which permits unexamined build-up of exposure in institutions that deal separately with all their counterparties. The Chairman's feeble suggestion of a regulator-approved form for expressing gross derivatives exposure is clearly prompted by the need to counter the SEC's already announced and much more revealing disclosure standards for such instruments.

The public benefit of regulation in the financial markets is not the ability of the government regulators to control the risk-taking proclivities of the firms. In the end, the regulators do not do that, anyway, and what we get is a bastard capital adequacy standard that requires only half as much capital to hold what may be very risky collateralized mortgage obligations as is required to hold what may be very safe whole mortgages--and a despairing standard for

the valuation of derivatives which permits banks to do their own as long as they can satisfy a regulator, any regulator, that they know what they're doing. In New York, the Federal Reserve Bank approved a code of conduct in derivatives trading that permits a bank to cite a price to a customer without any commitment to do business at that price, an action for which a non-bank securities dealer subject to NASD rules could lose his license.

The important question, especially looking forward to a market-dominated future, is the information the regulators require regulated entities to make available to the public and to the markets. By these criteria, the Fed's recommendations fail, and always will fail, because of the contradiction between the bank secrecy that is the source of their authority and the information demands of markets. The Comptroller's recommendations are even more deficient, and should be rejected out of hand. Rather than give the banking regulators authority over securities activities, the SEC should be given authority to impose Financial Accounting Standards Board rules on banking institutions. Mr. Greenspan is right to call for enhanced market discipline in banking, but effective market discipline requires much more disclosure than he is willing to permit.

#